

MAY 10 1991

Chief, Examinations Division, [REDACTED]
Attn: [REDACTED]

Assistant Chief Counsel (Income Tax & Accounting)

By (signed) Thomas A. Luxner

Thomas A. Luxner, Chief, Branch 7 (Income Tax & Accounting)

[REDACTED]

This memorandum is in response to your Technical Coordination Report ("TCR"), which recommends changes to the regulations under section 263A of the Internal Revenue Code. In particular, [REDACTED] of your office has pointed out that taxpayers are avoiding application of the uniform capitalization rules with respect to indirect costs relating to inventory property received in a nontaxable exchange under section 351(a).

In accordance with information presented in your TCR, the [REDACTED], is a public utility company providing both electric and natural gas to customers in several states. On [REDACTED], [REDACTED] formed a wholly owned subsidiary in a nontaxable exchange under section 351(a). [REDACTED], the newly formed corporation received the transferor's basis in the property transferred in accordance with section 362(a)(1). Further, because the newly formed corporation is a new taxpayer, the taxpayer is not required to restate the balance of inventory acquired in the nontaxable transfer for purposes of section 263A.

Section 1.263A-1T(e)(10) of the temporary regulations provides an anti-abuse provision regarding nontaxable transfers of inventory property that are made after September 18, 1986. Specifically, taxpayers that engage in nontaxable transfers under section 351(a) must restate beginning inventory balances as though the transferred assets had remained in the hands of the transferor. However, these rules do not apply to taxpayers such as [REDACTED] that made transfers prior to the 1986 date. In addition, because [REDACTED] uses the last-in, first-out (LIFO) method of accounting, section 263A would never apply to any of the inventory, including inventory remaining in LIFO layers, transferred under section 351(a) prior to the 1986 date. Consequently, [REDACTED] may avoid capitalization of certain indirect costs.

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█████ adopted the uniform capitalization rules and in █████ filed a Request for Change in Method of Accounting (Form 3115), electing to use the facts and circumstances method of cost allocation provided in section 1.263A-1T(e)(6) of the temporary regulations. Under this method change, the taxpayer revalued its inventory based on a factual assessment of all direct and indirect costs associated with such inventory. █████ took its section 481(a) adjustment into income over two years as required by section 263A.

The indirect costs incurred in █████ and █████ required to be capitalized under section 263A of the Code were offset by the █████ tax year decrement. Few of █████'s indirect costs associated with its █████, █████, and █████ tax years have been capitalized because such costs are either offset by the █████ decrement or relate to inventory transferred in the █████ nontaxable transfer. █████ estimates that █████ would have been required to capitalize \$█████ of indirect costs relating to inventory if there had not been a nontaxable transfer.

Subsequently, █████ filed a second Form 3115 for the tax year ending █████ seeking to use the simplified resale method provided in section 1.263A-1T(d)(3) of the temporary regulations. The primary difference between the simplified resale method and the facts and circumstances method is that certain costs, such as storage, are computed on the inventory increment and not on all inventory held by the taxpayer. █████'s principal costs subject to section 263A are storage costs. Because █████ has no increment, none of its current storage costs will be capitalized.

Although permission has not yet been granted in this method change request, both the current method as well as the requested method are permissible methods under section 263A of the Code. If the method change is granted, █████ will continue to virtually avoid the uniform capitalization rules. █████ notes that it is inequitable for █████ to escape capitalization of such costs while other taxpayers in the same industry that did not engage in a nontaxable transfer under section 351(a) must capitalize such costs. █████ suggests that the Service limit use of the simplified resale method and prohibit taxpayers that have undergone a nontaxable transfer from adopting the method.

We appreciate █████'s suggestion and bringing this important issue regarding the operation of the temporary regulations under section 263A to our attention. █████'s TCR provides significant detail to aid a thorough review of the issue. We will consider █████'s suggestions as we finalize the section 263A regulations. Ellen McElroy of my office is the principal author of these regulations, and therefore, if you or

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anyone in your office have additional questions regarding this matter, please contact her at (202) 566-5155. Again, many thanks for [REDACTED]'s suggestions.